

Office of Chief Counsel
Internal Revenue Service
memorandum
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date: MAR 20 2000

to: Examination Division, Laguna Niguel
ATTN: Randy Mita, International Examiner, SP:1413

from: Associate District Counsel, Southern California District, San Diego

subject: [REDACTED]
Imputed Interest on Accounts Payable Pursuant to I.R.C. § 482

This memorandum addresses arguments made by [REDACTED] (the "Taxpayer") in response to our advice rendered on January 3, 2000, relating to whether, for the taxable years ending March 31, [REDACTED] through March 31, [REDACTED] and the short-year ending December 31, [REDACTED], the Service should impute interest pursuant to section 482¹ on "overaged" accounts payable due from the Taxpayer to its parent and affiliated companies.

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

¹ All section references are to the Internal Revenue Code in effect for the tax years in issue, unless otherwise indicated.

FACTS

See our memorandum dated January 3, 2000, for a complete statement of facts in this case.

The Taxpayer has responded to the Service's analysis regarding the application of section 482 to this case with the following arguments:

First, and most importantly, how can the IRS ignore the express application of Prop. Reg. § 1.7872-5(c)(2), by stating that "neither [REDACTED] nor the affiliate from whom Taxpayer purchased its products conducted a trade or business within the U.S. during the years at issue" when the application of this provision necessarily requires that no foreign person be engaged in a U.S. trade or business (as was the case)?

Second, how can Treas. Reg. § 1.1441-2(e)(2) apply to the tax years under audit, when they do not go into effect until December 31, 1999 [sic] 2000?

Third, why can the IRS attempt to impose a withholding tax under sections 1441 and 1442, for an income tax provision under section 482 if there is no actual case law or existing regulatory authority (as tacitly acknowledged) when the IRS states, "Arguably, the Taxpayer need not make an actual payment for sections 881, 1441 and 1442 to apply" when no interest payments were made nor required under Prop. Reg. § 1.7872-5(c)(2)?

Fourth, why can the "Service . . . impute interest under section 482, regardless of whether it also may apply section 7872" when Regulations 1.482-2(a)(3) specifically provides for an ordering application of Section 482 and other sections such as 467, 483, 1274 and 7872?

Finally, even if an imputation of interest is warranted under section 482, which is an income tax provision (as "482 focus[es] on preventing the shift [sic] of income among controlled parties and placing controlled taxpayers on a tax parity with uncontrolled taxpayers by determining the true taxable income of controlled taxpayers"); why would this not reduce the taxable income to the Taxpayer under Section 482 by shifting interest income from the U.S. Taxpayer to the

foreign affiliate? This of course acknowledges that Section 482 is an income tax provision, distinct from Sections 881, 1441 and 1442 which are withholding tax provisions.

DISCUSSION

I. RESPONSE TO THE TAXPAYER'S ARGUMENTS

It appears from the Taxpayer's response that you provided it with a copy of our advice. We recommend that you do not do this in the future, because you may be treated as having waived the attorney-client privilege. See Disclosure Limitations, above. While you may convey the essence of our analysis to the Taxpayer and cite to cases to which we cite, we recommend that you avoid quoting verbatim substantial portions of our analysis.

See our memorandum dated January 3, 2000, for a complete discussion of the application of section 482 to the facts in this case. Below is a response to each of the Taxpayer's five arguments.

Argument 1: How can the IRS ignore the express application of Prop. Reg. § 1.7872-5(c)(2), by stating that "neither [REDACTED] nor the affiliate from whom Taxpayer purchased its products conducted a trade or business within the U.S. during the years at issue" when the application of this provision necessarily requires that no foreign person be engaged in a U.S. trade or business (as was the case)?

As discussed in our prior memorandum, we agree with the Taxpayer that section 7872 does not apply to this case. See memorandum dated January 3, 2000, p. 5. Therefore, it is unclear what the Taxpayer is arguing or why the Taxpayer believes we have "ignore[d] the express application of Prop. Reg. § 1.7872-5(c)(2)."

As we stated in our prior memorandum and as we discuss below, however, the application of section 482 is not dependent on the application of 7872. Therefore, the fact that section 7872 does not apply to this case is not relevant.

Argument 2: How can Treas. Reg. § 1.1441-2(e)(2) apply to the tax years under audit, when it does not go into effect until December 31, 2000?

In our prior memorandum, we specifically stated that Treasury Regulation § 1.1441-2(e)(2) does not apply to the taxable years at issue. See memorandum dated January 3, 2000, p. 10. We cited to Treasury Regulation § 1.1441-2(e)(2) for the sole purpose of showing that the Service's position on the issue had not changed. That is, we noted that neither the preamble to the regulation nor the regulation itself indicates that the regulation was intended to reflect a change in the Service's position. See id.

Argument 3: Why can the IRS attempt to impose a withholding tax under sections 1441 and 1442, for an income tax provision under section 482, if there is no actual case law or existing regulatory authority and when no interest payments were made nor required under Prop. Reg. § 1.7872-5(c)(2)?

The Service is not precluded from imposing a withholding tax under section 1442 on interest imputed pursuant to section 482, simply because there is no case law or regulations addressing the specific issue. Nothing in the text of sections 1441 or 1442 conditions the effectiveness of those sections on the issuance of regulations or limits the scope of those sections to interest stated in a loan agreement. Indeed, Treasury Regulation § 1441-2 defines "interest" to include interest imputed pursuant to section 483. Treas. Reg. § 1.1441-2(a)(1).²

Moreover, courts often decide cases of first impression and without the assistance of interpretative regulations. See Estate of Neumann v. Commissioner, 106 T.C. 216, 218, 222 (1996); see also, H Enter. Int'l, Inc. and Subsidiaries v. Commissioner, 105 T.C. 71, 81-85 (1995). For example, the district court for the Eastern Division of New York did not have any difficulty in applying the withholding requirements of sections 1441 and 1442 to interest imputed under section 7872, even though the regulations promulgated under sections 1441 and 1442 did not specifically include imputed interest under section 7872 within the definition of "interest." Climaco v. Internal Revenue Service, 94 CV 2272, 96-1 USTC ¶ 50,153 (E.D.N.Y. January 19, 1996) (not for publication).

Argument 4: Why can the Service impute interest under section 482, regardless of whether it also may apply section 7872, when Treasury Regulation § 1.482-2(a)(3) specifically provides an ordering rule for sections 482, 467, 483, 1274 and 7872?

² as effective for the years at issue.

Treasury Regulation § 1.482-2(a)(3) does not state that section 482 cannot apply, if section 7872 does not apply. In fact, it states just the opposite:

(Whether or not the other Internal Revenue Code section applies to adjust the amounts treated as interest under such loan or advance, section 482 and paragraph (a) of this section may then be applied by the district director to determine whether the rate of interest charged on the loan or advance, as adjusted by any other Code section, is greater or less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

Treas. Reg. § 1.482-2(a)(3)(iii) (emphasis added). In addition, the regulation contains examples clearly illustrating that the regulation contemplates that section 482 may apply in cases where section 7872 does not. See Example 3 of Treas. Reg. § 1.482-2(a)(3) (section 7872 does not apply to the transaction, but section 482 does).

Argument 5: Even if an imputation of interest is warranted under section 482, why would this not reduce the taxable income to the Taxpayer under section 482 by shifting interest income from the Taxpayer to its foreign affiliates?

We agree that the Taxpayer is entitled to a deduction for interest imputed to the Taxpayer's affiliates pursuant to section 482. As a side note, section 881 is not a withholding provision; it imposes a tax of 30 percent on certain income not effectively connected to the conduct of a U.S. trade or business.


Note: Please review our comments and recommendations, below, relating to this issue.

II. OTHER COMMENTS AND RECOMMENDATIONS

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If you have any questions, please call the undersigned at
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Attachment

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